United States Court of Appeals
for the Second Circuit

BRIEF FOR APPELLANT

ORIGINAL

11-2

76-6175

To be argued by
MICHAEL C. DEVINE

IN THE

United States Court of Appeals

For the Second Circuit

B

P/S

SECURITIES AND EXCHANGE COMMISSION,
Plaintiff-Appellee,

against

COMMONWEALTH CHEMICAL SECURITIES, INC., *et al.*,
Defendants-Appellants.

On Appeal from the United States District Court for the Southern District of New York

BRIEF FOR DEFENDANTS-APPELLANTS COMMONWEALTH CHEMICAL SECURITIES, INC., *et al.*

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ISSUES PRESENTED FOR REVIEW

1. Were the findings of the district court that each of the defendants violated the securities laws clearly erroneous?

2. Were the defendants entitled to a jury trial in the court below?

3. Does the fact that the claimed liability of each of the defendants was adjudicated by the district court based upon the application of a "negligence" standard require reversal and a new trial?

4. Were the findings of the district court respecting profit disgorgement clearly erroneous?

STATEMENT OF THE CASE

A. The Nature of the Case.

Plaintiff, the Securities and Exchange Commission ("SEC"), brought this action pursuant to various provisions of the federal securities laws -- sections 5 and 17(a) of the Securities Act of 1933 ("1933 Act"), sections 10(b), 15(c), and 17(a) of the Securities Exchange Act of 1934 ("1934 Act"), sections 17(a), 17(d), 36(a), 37, and 48(a) of the Investment Company Act of 1940 ("1940 Act"), and sections 206(1) and (2) of the Investment Advisers Act ("Advisers Act").

Defendant-appellants are Commonwealth Chemical Securities, Inc. ("Commonwealth"), which prior to mid-1973 was a securities broker-dealer; DK&B Management, Inc. ("DK&B"), which prior to mid-1973 was the investment adviser for two investment companies, N.Y. Hedge Fund and Vanguard Fund; Robert Drucker and Julius Kleinman, formerly officers of Commonwealth and DK&B; Mary Sharpe, formerly a bookkeeper at Commonwealth; and Marlane Kleinman, Julius Kleinman's wife.

Commonwealth and DK&B were long since out of business when this action went to trial (some three years after the alleged events), and the individual defendants had long since terminated all connection with the securities industry.

At the conclusion of the trial, counsel for defendant Dorothy Drucker moved to dismiss the complaint, and the following colloquy ensued:

> THE COURT: Where is your proof that Dorothy Drucker ever got a nickel for herself?
>
> MR. BENOWITZ: Well, we don't have any proof at this moment.
>
> THE COURT: How can you have me disgorge profits from here, then?
>
> MR. BENOWITZ: She may have received transfer profits from her husband.
>
> THE COURT: She may have received an elephant from the Shah of Iran, but there is no proof that she did. (R388;).

A similar motion to dimiss was made on behalf of defendant Marlane Kleinman (R390;). As to both motions the district court reserved decision, saying:

> "...we are here concerned with each of these individuals and a case must be made as to each of them, not just some broad brush." (R391;).

Yet plaintiff did not make a case as to any defendant, and despite its own warning the district court erroneously painted with the broadest conceivable brush.

B. The Course of Proceedings and Disposition Below.

A preliminary injunction hearing was commenced on May 29, 1974, but was terminated by stipulation before any decision.* The trial was held in April and May, 1975, before Hon. Lloyd F. MacMahon, sitting without a jury, despite defendants' continuing demand for a jury trial. In its decision (402a) and supplemental decision (459a) the district court held that all defendants should be enjoined, and further awarded so-called "ancillary relief" directing defendants to pay some $405,541.25 to an escrow agent for an ultimate, but unspecified, distribution to public stockholders.

C. Summary of Argument.

The district court correctly found plaintiff's case to be "incoherent" and "incomprehensible". (D2; 403a). The court erred, however, in not recognizing that the incomprehensibility derived from the insufficiency of the evidence. Plaintiff did not satisfy its burden of proof. This is most obvious with respect to certain of the individual defendants (e.g., Marlane Kleinman, who was enjoined despite the fact that no witness as much as mentioned her name), but it is true as to every aspect of the case.

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* The district court decision is in error in stating that a preliminary injunction was granted. (D3).

STATEMENT OF THE FACTS

Commonwealth, a securities broker-dealer, underwrote a public offering of units of Beneficial Labs, Inc. securities (a unit consisting of one share of common stock and a warrant to purchase an additional share at $2.25). In the offering each unit was priced at $2.25.

As described in the offering circular (PX3; 60a), dated December 20, 1971, the minimum number of units to be sold was 50,000, and the maximum was 100,000. The offering was to have a 90-day duration -- from December 20, 1971, through March 20, 1972.

By March 10, 1972, ten days prior to the expiration of the offering period, Commonwealth had sold 50,650 units, 650 more than the 50,000 unit minimum. (PX6; 78a). Therefore, in accordance with SEC instructions to close as soon as the minimum had been sold, a closing was held immediately. It was attended by counsel for the issuer and by counsel for Commonwealth, neither of whom is a defendant in this action. No defendant in this action was present at the closing. Commonwealth's counsel delivered the net proceeds of the offering to the issuer's counsel.

A third attorney, who formerly had been an SEC staff attorney, also was present. (R252-253; 223-224a).

Gross proceeds (50,650 x $2.25)	$113,962.50
Commonwealth commission	19,967.75
Net proceeds	$ 93,994.75*

After the closing the Beneficial securities began trading in the over-the-counter market, and continued until March, 1973, when the SEC suspended trading for several months.

The district court found that the offering had been closed improperly, despite the fact that it was accomplished solely by counsel, none of whom are defendants, and that the after-market trading had been manipulated, despite the fact that no meaningful evidence of manipulation was offered. Those findings are clearly erroneous.

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* Apparently due to last-minute adjustments an extra $39 was delivered, total $94,033.75.

POINT I

THE SEC FAILED TO PRESENT EVIDENCE SUFFICIENT TO PROVE ITS CASE AND THEREFORE THE DISTRICT COURT'S FINDINGS ON LIABILITY WERE CLEARLY ERRONEOUS

There are four individual appellants represented on this brief. The evidence, or lack thereof, is very different as to each individual, and therefore each must be treated separately.

(1) Marlane Kleinman. No witness at the trial as much as uttered Mrs. Kleinman's name. Exhibit 10, which was received in evidence over defendants' objection, indicates that Mrs. Kleinman bought 600 units of Beneficial Labs in her account at Merrill Lynch (which was in her maiden name), and later sold 500 of the units through the same account, realizing $218.75 gain, which was subsequently offset by a loss on the remaining 100 units. That is all there is.

From this the district court concluded that Mrs. Kleinman was "in a position to know" that her purchase would affect the price of the units, which the court concluded had come from Commonwealth. This is a flight of speculation for which there is not one whit of evidence.

(2) Julius Kleinman. The record establishes the following facts regarding Mr. Kleinman: he was a shareholder

and officer of Commonwealth (A; 49a); he was an officer of DK&B (A; 49a); he was a director of N.Y. Hedge Fund and Vanguard Fund (A; 50a); he made investment decisions for Regina Sinofsky's brokerage account (R32;115a); he attended a "due diligence" meeting at the SEC (154a); he wrote a letter to the SEC stating that more than 50,650 units had been sold (PX6; 78a); he spoke to Mr. Wolff (a securities trader) and stated that 5,000 shares of Environmental Devices should be delivered to a bank in New York (R40; 121a); and he is Mr. Arner's nephew (R340;311a). No attempt was made to prove any other fact concerning Mr. Kleinman.

There is no showing that Mr. Kleinman ever caused a single purchase or sale of Beneficial securities; no showing that he engaged in any conspiratorial conversations; no showing that he made a single false statement. In short, no showing that any material allegation of the complaint is true as to him.

(3) Mary Sharpe. Miss Sharpe, a 32-year old bookkeeper, was employed by Commonwealth in a purely clerical capacity. She did not deal with customers, did not make corporate decisions, did not in any way participate in management of the firm, and did not buy or sell securities on behalf of the firm or its customers.

A single thread brings her into this action, and on it alone the district court hung her liability. In

the public offering, using her own funds, Miss Sharpe purchased 1000 Beneficial units for her mother, and in her mother's name (Nellie Pyles). (R226; 197a). Commonwealth's attorney advised her that the purchase did not violate SEC regulations. (R229-230;200-201a). Due to an intervening disagreement, Miss Sharpe did not pass on to her mother the profits of the later sale of 500 of the units. (R231; 202a).

No other facts were offered by the SEC in support of their action against Miss Sharpe. There was no showing that her purchase was in any way influenced by any other defendant, nor part of any "scheme". There was no showing of any conversation or agreement between Miss Sharpe and any other defendant. There was no showing that any other defendant supplied any of the funds used in the purchase, or received any of the proceeds. There was no showing that any other defendant had any interest in, or control over, Miss Sharpe's purchase.

> Q Did you ever have a discussion with Mr. Drucker concerning the account that you had opened for your mother concerning which securities should be bought or sold in that account?
>
> A In my mother's account?
>
> Q Yes.
>
> A No, no.
>
> Q Who made the investment decisions for that account?

A I did.

Q And how did you go about making such investment decisions? Did you consult anybody?

A Not really, no. Only Mr. Brown before I purchased. (R234-235; 205-206a).

["Mr. Brown" is the attorney upon whom Miss Sharpe relied.]

In short, Miss Sharpe made her isolated purchase and sale alone, with her own funds, on the advice of counsel. It is not possible to find a violation of the federal securities laws in those facts.

(4) Robert Drucker. Unlike the other individual defendants, some considerable mention was made of Mr. Drucker at trial. However, the evidence lacked weight sufficient to support the judgment against him.

Judge MacMahon divided the case against Mr. Drucker into three separate categories; the offering (D6; 407a); manipulation (D17;418a); and the fund transactions (D29;430a). Plaintiff did not carry its burden of proof in any one of the three areas.

(a) The offering. The court below found that on March 10, 1972, Commonwealth had not sold the minimum number of Beneficial units, and on that single premise it based all of its conclusions concerning the unlawfulness of Mr. Drucker's participation in the

offering. Therefore, those conclusions rise or fall with the validity of that premise.

The sale of more than the minimum number of units is shown by the following evidence:

-- the letter of March 8, 1972, from Commonwealth to the SEC lists buyers for more than 50,000 units (PX6;78-79a);

-- Commonwealth had collected the required amount to close, $94,033.75, being the net proceeds for sale of 50,650 units, and it transmitted those funds to Beneficial (PX4;77a), retaining its own commission;*

-- Mr. Drucker testified that more than 50,000 units had been sold by March 10, 1972 (R322;293a)

The district court chose to ignore that evidence on the ground that three of the component sales were not bona fide; namely the sales to Pyles, Pavel, and Massad. In making that finding the court erroneously equated sales consummated in nominee names with non-sales. Legal and beneficial ownership often are divided, and such was the case with the Pyles, Pavel, and Massad sales. In each instance a person other than the record owner had a beneficial interest, but that of course does not mean that there was no sale -- quite the opposite. All of the shares were paid for and delivered. None of the funds

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* The district court findings agree with this calculation. (D8;409a).

used to pay for the shares came from Commonwealth, Drucker, or Kleinman.*

The units purchased in the accounts of Pavel and Pyles also were paid for in full, in timely fashion, with private funds, independent of Commonwealth, Drucker, or Kleinman. The SEC offered no evidence to the contrary.

The purchasers in the offering were not misled. They were told truthfully that at least 50,000 units would be sold.

The conclusion that the offering was undersold is belied further by the fact that the closing occurred ten days early. The offering period did not expire until March 20, 1972, whereas the closing occurred on March 10, 1972 (indeed 50,650 units had been sold by March 8, 1972 (PX6; 78-79a)). If Commonwealth actually had not sold more than 50,000 units it certainly would have used the remaining ten days in that pursuit. In truth, by March 10, 1972, Commonwealth had the funds for sale of 50,650 units, and therefore, by SEC instruction (R95; 160a)

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* The district court tried to bolster its disregard of the Massad purchase by emphasizing an administrative delay in completing delivery to Mr. Massad. (D10; 411a). However, the undisputed testimony is that Commonwealth's bank gave it unrestricted, immediate credit on the Massad sale on March 10, 1972 (R375; 343a), and therefore there was no delay in payment. Indeed, Mr. Massad's bank accepted delivery and made payment prior to March 20, 1972, the date by which the offering was to be closed. The court refused to admit an affidavit from an officer of the bank confirming this series of facts and acknowledging what the banks statement said. The SEC deposed Mr. Massad, but at trial offered neither the transcript nor Mr. Massad in person.

Similarly, the court emphasized that "Commonwealth" bought back Mr. Massad's stock. (D11; 412a). That is purely false. The testimony was that Mr. Drucker bought the stock, some substantial time after the offering, at the then market price. (R318; 289a).

it was required to conduct the closing.

(b) The alleged manipulation. The district court decision recites three factual premises for the conclusion that Mr. Drucker manipulated the after-market prices of Beneficial securities. First the defendants allegedly participated in 51 to 70 percent of the transactions in a particular sample of the transactions in Beneficial securities. Second, the transactions allegedly were "bad faith" transactions.

Again, the premises do not withstand scrutiny. the "51 to 70 percent" statistics are wholly artificial. Plaintiff's charts (PX 7, 9, and 10; 80a,89a, and 93a) purport to show all transactions in Beneficial securities. However, on voir dire examination the SEC employee who prepared the charts admitted that in creating the charts he had made inquiry of only 20 or so broker-dealers. He claimed that he did not know how many securities broker-dealers there are in the country, but it cannot be disputed that there are several thousand. Thus the charts cannot possibly show all transactions; nor can they show a statistically valid sample when only a small fraction of one percent of the relevant universe was checked.

The erroneous admission of these charts manufactured by the SEC goes to the heart of this appeal. The facile manner in which they were accepted, despite valid evidentiary objections, is in stark contrast to the district court's rejection of every exhibit (save one) offered by the defendants. In essence the SEC was accorded a "special litigant" status, the court accepting everything they offered "for what it was worth", it being "a non-jury case", while taking virtually nothing offered by the defendants. Certainly if the court were capable of weeding out the non-probative aspects of SEC exhibits, and for that reason accepting them over objection, it should have been capable of doing the same thing with respect to defendants' proferred exhibits.

The SEC's charts were prepared from completely unreliable material, by an individual completely lacking in professional training.* Many pages

* Mr. Judkowitz, the preparer, is not an accountant, not a lawyer, not an actuary, not a registered broker-dealer, nor a member of any other licensed profession relevant to preparation and presentation of complicated, numerical evidence of the critical importance accorded these charts. It should be noted that the district court denied admission of charts prepared by the defendant Drucker on the ground that he was not an expert, nor an accountant, lawyer, or actuary.

could be devoted to examples of the inaccuracies in the charts (see additional discussion in Point IV, infra), but a single illustration is sufficient to show the magnitude of the inaccuracies. The largest single transaction on any of the three charts is an alleged sale by Mr. Drucker of 10,000 shares of Beneficial Labs common stock to Investors Indicators Fund, on January 30, 1973, supposedly a $100,000 sale. (PX7; 86a). The support for this alleged transaction is two slips of paper contained on Exhibit 8. (87-88a). Even a hasty examination of those slips of paper reveals that Mr. Drucker did not sell 10,000 shares, but rather 3,250 shares. Hardly a minor error, in that it exaggerates Mr. Drucker's sales and profit calculations by as much as $67,500. Participation percentages similarly are exaggerated by this erroneous entry. The chart shows Commonwealth Chemical as agent for the buyer, whereas Exhibit 8 (the back-up documents) shows that Commonwealth was not the buyer's agent. The chart shows Mr. Drucker as the sole seller, whereas Exhibit 8 shows three sellers.

This is but one example.

Even if the SEC's charts had been at all meaningful, the manner in which the district court worked from those charts to arrive at its "51 to 70 percent" statistics would have been fallacious. In calculating this very uncertain statistic (a 19 percentage point spread), the court included transactions in which one defendant sold directly to another defendant, without any involvement by the public or other broker-dealers. Such transactions obviously had no impact on the public markets, and could not be relevant to any claim of manipulation. The court also counted "transactions participated in", rather than "participants", with the effect of doubling the percentages.* Additionally, the court included transactions in which

* This can be illustrated by a simple example. Assume that there were 10 transactions, that one defendant or another was the buyer in 5 transactions, and that some other defendant was the seller in 6 transactions. Using the district court's method of calculation one would conclude that defendants "participated in" 110 percent of the transactions. The true statistic would be half of that number; i.e., defendants constituted 55 percent of the "participants". Therefore, the district court's reference to "51 to 70 percent" is at most "25.5 to 35 percent".

defendants were sellers rather than buyers. Such transactions could not have caused any increase in the market price, and certainly should not have been considered in assessing potential manipulative effect. Selling exerts downward pressure on price, and therefore is the antithesis of an upward price manipulation.

Equally unfounded is the grouping, for statistical purposes, of accounts advised by Mr. Drucker with those advised by Mr. Kleinman. There is no evidence of any joint decision-making as to the grouped accounts. For example, Mrs. Drucker said that Mr. Drucker made the investment decisions for her account, not Mr. Kleinman. Similarly, Mrs. Sinofsky said that Mr. Kleinman made the investment decisions for her account, not Mr. Drucker. Thus there was no basis for the particular account grouping employed by the district court, and that contributed further to the statistical inaccuracy.

Eliminating these blatant inaccuracies, the only true finding which could be drawn from this record is as follows: based upon a statistically insufficient sampling of transactions it appears that

Mr. Drucker was the buy-side participant in 17 percent of the after-market transactions in Beneficial securities (less than 35 percent of the purchases) -- far from the "51 to 70 percent" found by the district court. Of course, a finding of 17 percent participation would negate a conclusion of illegal manipulative activity, particularly so with a security such as Beneficial Labs which was newly issued to the public. Trading of new issues often is inactive, commonly referred to as a "small float" or a "thin market" and Beneficial Labs was no exception. In such circumstances it is the obligation of the underwriter to maintain an orderly after-market, and in doing so it normally will participate in a large percentage of the transactions. Thus a high participation percentage is a meaningless statistic -- it more readily connotes maintenance of an orderly market than it does manipulation. The SEC concedes that in virtually all new issues the underwriter participates in a large percentage of the after-market transactions.

> Every over-the-counter dealer who "specializes" in a security, in the sense that he effects a high percentage of the transactions in the security, and in the sense that he is the principal buyer and seller and is most familiar with the affairs of the issuer and the state of the market, to some extend dominates the market in that security. His trading volume may be the backbone of the market in the security and his determination to pay more or less may be determinative of market movements. Norris & Hirshberg Inc. 21 SEC 865, 874 (1946).

To bolster its precarious statistical analysis the district court branded certain transactions "bad faith" transactions. (D21; 422a). Neither the statutes nor precedent case law define, or assign any signficance to, a "bad faith" transaction, and the district court made no attempt to provide any definition or describe the purported significance of the term. Whatever it is, it is not evidence of manipulation.

The transactions between Commonwealth and Cabot-Shaw are an example. In a fully open and lawful manner Commonwealth purchased securities <u>other than Beneficial</u> from Cabot-Shaw, and Cabot-Shaw purchased Beneficial Labs securities from Commonwealth. The dollar amounts of the purchases were not equivalent -- Commonwealth paid $34,875 for the securities it purchased, and Cabot-Shaw paid $70,000 for the Beneficial Labs securities. (D23; 424a). The purpose, as identified by the SEC's

witness (R44;125a), was diversification of holdings. One might describe the transactions as contemporaneous sales, but such things are commonplace and plainly lawful, and therefore the SEC chose to use the term "swap", which sounds more devious and pedestrian. In truth the transactions were independent (the SEC made no effort to prove that there was any agreement between Commonwealth and Cabot-Shaw as to disposition of the securities, and in fact there was none). The district court, seemingly realizing that the sales were lawful, resorted to this novel "bad faith" stigmatization, which is all the more meaningless when one recognizes that these inter-dealer transactions were not publicly reported (as transactions on national stock exchanges are), and therefore could not have had any effect on the price of Beneficial Labs securities.

In sum, the district court erroneously built its finding of manipulation on a transparently fallacious statistical slight-of-hand, bolstered by branding admittedly lawful sales as "bad faith" transactions. One combs the record in vain for any direct evidence of manipulative activity.

Critical to any manipulation case is proof of artificial price quotation, but one hunts in vain in this record for testimony of a single market-maker suggesting

that he set his price for Beneficial securities on any basis other than his independent assessment of supply, demand, and anticipated price movement.

SEC v. Resch-Cassin & Co., Inc., 362 F. Supp. 964 (SDNY 1973), which is relied on heavily by plaintiff, identifies four indicators of stock price manipulation. None of the four are present here: (1) price leadership -- in the present case Commonwealth was out of the pink sheets for substantial periods of time during the alleged manipulation, e.g., October-December, 1972 (PX11;   ) and during this period there was a moderate price rise with Commonwealth being a seller, on balance; (2) domination and control of the market -- in the present case there is no reliable evidence of the true market activity (see discussions of exhibits 7, 9, and 10); (3) reduction in the floating supply of the security -- in the present case plaintiff did not even attempt to prove such reduction (in fact, the stock split 2-for-1 in early 1973, increasing the float); and (4) collapse of the price when the manipulator's activity ceases -- in the present case the price declined after the SEC suspended trading, but it did not collapse.

No manipulation was proved, nor could it have been proved without a demonstration that defendants had

an intent to create "actual or apparent active trading" (see by analogy, 15 U.S.C. §78(i)(a)(2)). No such intent was proved, nor did the district court make any such finding. See Masland Fernon & Anderson, 9 SEC 338 (1941); SEC v. Bennett, 62 F.Supp. 609 (SDNY 1945).

The district court correctly described plaintiff's case as "incoherent" and "incomprehensible"; however, it erred in trying to cure by speculation and statistical prestidigitation the absence of proof of manipulation.

(c) Fund transactions. On occasion Commonwealth sold Beneficial securities to other dealers, who sold the same securities to either N.Y. Hedge Fund or Vanguard Fund. The investment decisions of those funds were made by DK&B. Apparently because Mr. Drucker was an officer of Commonwealth (an occasional seller of Beneficial Labs securities) and also an officer of DK&B (the adviser to the funds which were occasional buyers of Beneficial Labs securities) the district court erroneously found "self-dealing" and "conflict of interest". (D30; 431a).

Officers of securities dealers also may be advisers to investment companies. Neither the 1940 Act nor the Advisers Act prevents such a dual role. Nearly every major investment company in the country has within its advisory group several officers of brokerage firms. The federal policy is to encourage

investment companies to make use of the expertise available within the brokerage community, not to prevent it.

Nor do the statutes prohibit sale to an investment company of securities once owned by firms or persons advising that company. The practical impossibilities of tracing which would be inherent in any such rule are obvious. Section 17(a) of the 1940 Act prohibits direct sales only, making it clear that no violation can be established by tracing securities back to an "affiliated person".

That, however, is precisely what the district court did in this case. There is no proof of a single direct sale of Beneficial securities by any affiliated person to an investment company. The court tried to overcome this determinative impediment by reference to §48(a) of the 1940 Act, which is the general provision prohibiting the accomplishment of illegal acts through other persons. Reliance upon that section is misplaced, because no illegal act occurred. N.Y. Hedge Fund and Vanguard Fund purchased from firms such as Cabot-Shaw, Amherst Securities, and A.C. Kluger, none of which were in any way the alter egos of Commonwealth or any other appellant. They made independent decisions, used their own funds, and kept whatever profits or losses

were realized. There is absolutely no showing that these independent firms were controlled by any of the appellants, nor used, or received, any funds of any appellant. An employee of each firm testified for the SEC, but not one testified to any arrangement, conspiracy, or complicity. Every one tesified to having acted independently, with their firm's money at risk, a circumstance antithetical to any finding that they were alter egos of any appellant.

Obviously the district court indulged in an attempt to trace securities from an affiliated person, through intervening sales, to an investment company, but that attempt exceeded the parameters of the statute and constituted serious error.

The highly qualified firm of Willkie, Farr & Gallagher advised Mr. Drucker that N.Y. Hedge Fund and Vanguard Fund were free to purchase Beneficial securities as long as they did not purchase directly from Mr. Drucker or Commonwealth. (R282-284;253-255a).* That advice was correct, and it was corroborated by Mr. Brown an attorney who represented Commonwealth. (R259-262; 230-233a). The advice was relied upon by Mr. Drucker.

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* The record establishes that the funds which purchased Beneficial Labs securities did so at the market price; i.e., that they obtained what commonly is referred to as "best execution", the best price available. The SEC made no attempt to prove the contrary.

In summary, the evidence does not support any of the three categories of violation found against Mr. Drucker.

The absence of factual support for the district court's findings is accentuated when viewed against the rigorous legal prerequisites for injunctive relief.

> "An injunction in an SEC action is a drastic remedy, (Securities Exchange Commission v. Franklin Atlas Corp., 171 F.Supp. 711, 718 (S.D.N.Y. (1959)), historically designed to deter, not to punish. Hecht Co. v. Bowles, 321 U.S. 321, 329 (1944). Injunctions in SEC actions are 'subject to principles of equitable discretion.' Hecht Co. v. Bowles, 321 U.S. 321, 327 (1944). In the absence of a showing that further violations are to be reasonably expected this court does not believe any injunction is appropriate. Despite SEC arguments to the contrary, what it seeks is more than a mere prophylactic related to the specific facts of the case. The broad, all-encompassing injunction sought here against any conceivable future violations carries the strong inference that the court believes the defendants would violate the law but for the court's intercession, an inference this court believe to be too heavy to place on these defendants on as inadequate a showing as had been made here."

SEC v. Koracorp Industries, Inc. [1975-1976 Transfer Binder] CCH Fed. Sec. L. Rep. ¶95,532 (N.D. Cal. March 26, 1976).

Also cited with approval in SEC v. Bausch & Lomb, Inc., 420 F.Supp. 1226 (S D N Y 1976).

Whether the "drastic remedy" of injunctive relief is warranted depends upon the totality of circumstances. Proof of a single violation does not suffice.

> ...in the final analysis general equity principles do control and establishing the wrong will not necessarily establish the right to the requested relief.
>
> <u>SEC v. Parklane Hosiery Co., Inc.</u>, CCH Fed. Sec. L. Rep. ¶95,753 (at p. 90,695) (SDNY 1976).

See also, <u>SEC v. Management Dynamics, Inc.</u>, 515 F.2d 801, 807 (2d Cir. 1975); <u>SEC v. Geon Industries, Inc.</u>, 531 F.2d 39, 56 (2d Cir. 1976): <u>U.S. v. W.T. Grant Co.</u>, 345 U.S. 629, 633 (1953); <u>Chris-Craft Ind., Inc. v. Piper Aircraft Corp.</u>, 480 F.2d 341, 405 (2d Cir. 1973) <u>cert denied</u>, 414 U.S. 910 (1973).

The federal securities laws require a showing that the defendant "is engaged or about to engage in any acts or practices which constitute or will constitute a violation". (15 U.S.C. §77(t)(b)(1933); see also 15 U.S.C. §78(u)(e)(1934)). This requirement is not diminished because the SEC is the plaintiff. No special weight may be given to that fact. <u>SEC v. Frank</u>, 388 F.2d 486, 490-492 (2d Cir. 1968). Indeed the SEC recently sought in Congress, unsuccessfully, to change

the statute (1934 Act) to permit injunctions to issue upon the mere showing of a past violation, without proof of "propensity" or "likelihood". (S.249, which became the Securities Act Amendments of 1975 (6/4/75), omitted any change in the injunctive standards however.)

Two factors are of primary importance in determining the need for injunctive relief -- the amount of time which elapsed between the date of the alleged violation and the request for an injunction (see SEC v. Keller Industries, 342 F.Supp. 654 (SDNY 1972)), and whether there is a history of prior or subsequent violations (see SEC v. Parklane Hosiery Co., Inc., supra, at p. 90,696). In short, the SEC must establish that the defendant has a propensity for violation of the securities laws. Absent such proof the imposition of an injunction would constitute a punishment, which of course is not the purpose of an injunction.

> An injunction is intended to prevent further violations and not to punish for those that have already occurred. SEC v. Parklane Hosiery, Co., Inc., supra, at p. 90,696.

This action was commenced in May, 1974, more than 15 months after the last alleged violation, and the injunction was imposed on September 30, 1976, more

than three and one-half years after the last alleged violation, more than four and one-half years after the first alleged violation. During the first two years of that four and one-half year period all of the individual defendants terminated all connections with the securities industry.* The first prerequisite to injunctive relief therefore is lacking. The injunction was not sufficiently contemporaneous with the alleged violations.

Also lacking is the second prerequisite. Nothing in this record proves (or even suggests) that any defendant has any history or pattern of violations of the securities laws.

The isolated nature of the allegations in this actions are most obvious with defendants Marlane Kleinman and Mary Sharpe. Mrs. Kleinman was enjoined because she purchased 600 Beneficial Labs units in her account at Merrill Lynch and subsequently sold 500 units for a $218 profit. No other activity was alleged or proved -- no conversations, no agreements, no improper intent. All Mrs. Kleinman is quilty of is a simple, isolated, routine, lawful transaction, which does not constitute a violation of law. It certainly does not indicate a propensity for violations.

Mary Sharpe's situation is much

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* Mary Sharpe is presently a bookkeeper for a brokerage firm.

the same. She purchased and sold certain Beneficial Labs securities -- nothing more. One of the transactions was in her mother's name, and from that fact the SEC tried to create an illusion of impropriety. Miss Sharpe explained her use of her mother's name, and the SEC failed to rebut that testimony with any proof of deception or materiality. The public simply could not care less whether units were sold to "Nellie Pyles" or "Mary Sharpe". Indeed the public did not even know the identity of the purchaser. Again no violation was proved, and certainly no propensity to violation.

Although the allegations against Mr. Kleinman and Mr. Drucker encompass more transactions than those alleged against Mrs. Kleinman and Miss Sharpe, there is the same failure to demonstrate any propensity. Mr. Kleinman and Mr. Drucker were not in the securities business for any substantial period of time. They voluntarily had terminated all broker-dealer activities long before the injunction issued. By virtue of consents reached with regulatory agencies neither Mr. Kleinman nor Mr. Drucker may return to the securities business without the consent of the agencies involved. Neither presently is, nor has been, a director or officer of a publicly owned corporation, nor has any intention of obtaining

such a position.

In SEC v. Penn Central Co., CCH Fed. Sec. L. Rep. ¶95,867 (ED Pa. 1976), summary judgment was granted dismissing the complaint for injunctive relief against defendant Wynne. Mr. Wynne had submitted an affidavit describing his lack of involvement with publicly traded securities and the unlikelihood of any future involvement. The court conlcuded that those facts precluded all possibility of injunctive relief, making trial unnecessary.

Similarly, in SEC v. American Realty Trust, CCH Fed. Sec. L. Rep. ¶95,913 (ED Va. 1977), the court stated:

> A simple conclusion that illegal activity has occurred, without more, does not provide a proper basis for relief. (at 91,443)...
>
> In assessing all these considerations, even if the single violation discussed supra in fact occurred, injunctive relief would still be inappropriate. The SEC has failed to show that there exists a cognizable danger of recurrent violation, and therefore, has failed to make a proper showing for injunctive relief. Accordingly, plaintiff's request for a permanent injunction is denied. (at 91,444).

See also, SEC v. Weisberger, CCH Fed. Sec. L. Rep. ¶95,108 (SDNY 1975): SEC v. Pearson, 426 F.2d 1339

(10th Cir. 1970) (an injunction "would accomplish nothing but placing a stigma on appellee" (p. 1343)).

POINT II.

DEFENDANTS ARE ENTITLED TO A TRIAL BY JURY

Defendants demanded a jury trial in the court below. At the beginning of the trial the district judge struck this demand.

> "MR. DEVINE: Is it my correct understanding that you have ruled against the jury demand which has been filed in this case?
>
> THE COURT: No one has asked me to move against it, but if somebody would I would surely strike it out.
> I strike it out sua sponte. The plaintiff seeks totally equitable relief and you are not entitled to a jury here." (R4; 98a)

In so ruling the district judge erred. Where the SEC seeks a monetary award in this sort of proceeding under the doctrine of "ancillary relief", it is actually asserting a claim which is legal in nature. The claim in both substance and effect is no different from that of an individual investor for damages. Because it is essentially a legal claim, and despite its being coupled with a request for injunctive relief or cloaked as "disgorgement", defendants are entitled to a trial by jury on all issues concerning liability in this action.

It is well established that the right to a jury trial under the Seventh Amendment to the Constitution

extends to forms of action which were nonexistent at the time the Amendment was adopted.

> "Although the thrust of the Amendment was to preserve the right to jury trial as it existed in 1791, it has long been settled that the right extends beyond the common-law forms of action recognized at that time. Mr. Justice Story established the basic principle in 1830:
>
> > 'The phrase 'common law,' found in this clause, is used in contradistinction to equity, and admiralty, and maritime jurisprudence.... By common law, [the Framers of the Amendment] meant... not merely suits, which the common law recognized among its old and settled proceedings, but suits in which legal rights were to be ascertained and determined, in contradistinction to those where equitable rights alone were recognized, and equitable remedies were administered.... In a just sense, the amendment then may well be construed to embrace all suits which are not of equity and admiralty jurisdiction, whatever might be the peculiar form which they may assume to settle legal rights.' Parsons v. Bedford 3 Pet. 433, 446-447 (1830) emphasis in original)." Curtis v. Loether, 415 U.S. 189, 193 (1974).

The governing standard is:

> "whether the action involves rights and remedies of the sort traditionally enforced in an action at law, rather than in an action in equity or admiralty." Pernell v. Southall Realty, 416 U.S. 363, 375 (1974).

Accordingly, the Seventh Amendment guarantees the right to a trial by jury in a wide range of actions brought

under federal remedial and regulatory statutes. The Court in Curtis observed:

> "Petitioner nevertheless argues that the Amendment is inapplicable to new causes of action created by congressional enactment. As the Court of Appeals observed, however, we have considered the applicability of the constitutional right to a jury trial in actions enforcing statutory rights 'as a matter too obvious to be doubted.' 476 F.2d, at 1114. Although the Court has apparently never discussed the issue at any length, we have often found the Seventh Amendment applicable to causes of action based on statutes. See, e.g., Dairy Queen, Inc. v. Wood, 369 U.S. 469, 477 (1962) (trademark laws); Hepner v. United States, 213 U.S. 103, 115 (1909) (immigration laws); cf. Fleitmann v. Welsbach Street Lighting Co., 240 U.S. 27 (1916) (antitrust laws), and the discussion of Fleitmann in Ross v. Bernhard, 396 U.S. 531, 535-536 (1970)." 415 U.S. at 193-94.

It concluded that:

> "Whatever doubt may have existed should now be dispelled. The Seventh Amendment does apply to actions enforcing statutory rights, and requires a jury trial upon demand, if the statute creates legal rights and remedies, enforceable in an action for damages in the ordinary courts of law."

The claims asserted by the SEC in the instant action are for alleged violations of numerous provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934. Both of those statutes provide for civil

actions for monetary damages by individual investors. In such actions any defendant is entitled to a jury trial.

The SEC has also sought, and been granted, the right to obtain monetary recovery for violations of those same provisions of the securities laws whose violation gives rise to a cause of action by an individual investor. See SEC v. Texas Gulf Sulphur Co., 446 F.2d 1301, 1307-08 (2d Cir.) cert. denied 404 U.S. 1005 (1971), rehearing denied 404 U.S. 1064 (1972); SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1103-04 (2d Cir. 1972); SEC v. Shapiro, 494 F.2d 1301, 1309 (2d Cir. 1974). The means by which this is accomplished is an injunctive action in which the Commission also seeks "ancillary" relief for "disgorgement of profits", as it did here.

Of course none of the monies awarded go to the SEC. They are instead held in a fund to be paid out to individual investors.

Thus, although such an SEC action is literally not "a private affair involving those with whom the defendants had the transactions" SEC v. Golconda Mining Company, 327 F. Supp. 257, 259 (S D N Y 1971), it serves the same function, makes the same claims, and seeks essentially the same relief. The SEC is allowed to proceed on behalf of all private investors who may have been affected by the alleged violations and in effect to prosecute their claims for monetary recovery.

As this Court noted in SEC v. Manor Nursing Centers, Inc., supra, at 1105-06:

> "One of the chief reasons for requiring defendants to refund illegally obtained proceeds of a public offering is to compensate defrauded investors."

The substantial identity between the so-called "disgorgement" claim of the Commission and the damage claim of an individual investor is underscored by the manner in which that claim for "ancillary relief" has been defined and administered. As noted above, the proceeds of judgment become a fund from which individual investors are paid -- including those investors holding private damage judgments. See Texas Gulf, supra, at 1307: Manor Nursing, supra, at 1105; Shapiro, supra, at 1309; Golconda Mining, supra; SEC v. Penn Central Co., supra.

The amount of the award has been limited to the extent that it would not be recoverable by private plaintiffs:

> "While not conclusive, we think that it is significant that defendants in private litigation would not be required to pay defrauded purchasers the profits on the proceeds." Manor Nursing, supra, at 1104 (reversing a provision of a district court order reaching profits and income on proceeds),

and has been allowed to the extent it might be recoverable:

> "... stockholders who sold their shares to appellant might, absent his fraud, have retained and sold their shares on February 18 when

> the price was much more attractive rather than during the later period. The effect of appellant's fraud was to deprive them not only of the profits actually realized by appellant but also of the opportunity to sell when the price was much higher. We see no reason why the injured shareholders should not be compensated for this "lost opportunity." Shapiro, supra, at 1309.

An SEC injunctive proceeding under which "ancillary" monetary relief is sought in the form of "disgorgement of profits" is in effect a class action for damages in which the Commission is the class representative. Because of the statutory structure it is permitted to proceed concurrently with and parallel to private damage actions by individual investors -- even a class action for damages on behalf of all investors. Its virtual identity with such private actions, so far as what is claimed and what is sought, is well demonstrated by the recent discussion in the Penn Central case:

> "The fact that defendants have been sued in private litigation based on many of the same allegations as those made by the SEC does not make the relief sought any less remedial. Private suits do not necessarily restore the status quo. Disgorgement contemplates total recovery from the wrongdoer, not recovery that may be partial or limited to a few of the total number injured or subject to a compromise of actual damages. Obviously the SEC cannot be estopped by any prior suits since it was not a party to such actions. To the extent that defendants have made restitution, the amount paid would serve to offset part or all of a judgment for disgorgement.

> In the event that we deem disgorgement appropriate, defendants will have the opportunity to prove that they have already relinquished their ill-gotten gains." CCH Fed. Sec. L. Rep. ¶95, 867, at pp. 91,191-192.

In that same case it was further noted that:

> "The SEC had announced it would not seek disgorgement in this case if it felt that defendants had made appropriate contributions to the settlement of the private Penn Central Securities Cases, MDL 56. It is our understanding that the SEC continued with this suit because defendants have never disclosed the amount of money they paid into the fund." Id. at fn. 7.

The above noted position taken by the Commission tends to concede that the claim for "disgorgement" is in reality one for money damages in behalf of investors. While we recognize that the Commission may proceed independently of individual investor-plaintiffs -- and indeed persist in litigating the same facts and issues of the same monetary relief irrespective of a settlment of the same claims made on behalf of such investors by their duly appointed representatives and judically approved -- we submit that this cannot constitutionally be accompanied by the denial of a jury trial, in the SEC proceeding, to the defendant

under attack.*

The decision in Ross v. Bernhard, 396 U.S. 531 (1970), is of significance here. In that case, a stockholder brought a derivative action against the directors of a closed-end investment company and its broker (claimed to dominate the board), alleging a conversion of corporate assets and abuse of trust through the payment of excessive fees to the broker. The complaint sought an accounting and return of the allegedly unlawful profits. The Court of Appeals had held there was no right to a jury trial since a derivative action was traditionally an equitable remedy. Reversing, the Supreme Court found that the claims being pursued were essentially legal in character and if asserted by the corporation itself would have entitled either party to a jury trial. The opinion emphasized that the real party in interest, to which any recovery would flow, was the corporation. It stated:

> "legal claims are not magically converted into equitable issues by their presentation to a court of equity in a derivative suit." Id. at 538.

* A contrary ruling was recently made in SEC v. Petrofunds, Inc., 420 F.Supp. 958 (SDNY 1976). At the conclusion of that decision, however, Judge Weinfeld certified the issue pursuant to 28 U.S.C. §1292, stating the view that it "involves a controlling question of law as to which there is substantial ground for difference of opinion..." Id., at fn. 9. The application to this court for permission to take an immediate appeal in that case was subsequently withdrawn.

It further said that in determining the Seventh Amendment question

> "nothing turns... upon the form of the action or the procedural devices by which the parties happen to come before the court." Id. at 540.

Here, in respect of the SEC claim for monetary relief, the basic principles set forth in Ross apply. The beneficiaries of any judgment, those who will receive the proceeds of any recovery, are investors. The claim for money to be distributed to investors (in much the same way a class action award would be) is essentially a legal claim; it is not magically converted into an equitable claim by being characterized "ancillary". Nothing turns on either the identity of the named plaintiff or the procedural device which is utilized to assert that claim.

The controlling element is the nature of the claim itself. Being legal in character, it mandates a jury trial at the instance of the defendants. The governing rule was summarized in Ross, where referring to Beacon Theatres, Inc. v. Westover, 359 U.S. 500 (1959) and Dairy Queen, Inc. v. Wood 369 U.S. 469 (1962), the Court stated:

> "Under those cases, where equitable and legal claims are joined in the same action, there is a right to jury trial on the legal claims which must not be infringed either by trying the legal issues as incidental to the equitable ones or by a court trial of a common

issue existing between the claims. The Seventh Amendment question depends on the nature of the issue to be tried rather than the character of the overall action." 396 U.S. at 537-38.

Accordingly, the district court erred in denying these defendants a jury trial.

POINT III.

THE DISTRICT COURT ERRONEOUSLY APPLIED A NEGLIGENCE STANDARD IN DETERMINING THE LIABILITY OF THESE DEFENDANTS UNDER SECTION 10(b) and RULE 10b-5

The court below did not specifically state what standard of culpability it applied in determining the liability of the defendants, but adequately revealed what standard it was applying, in connection with discussing the liability of defendants Sharpe and Guttman:

> "It has been held that a negligence standard applies in measuring the civil liability of an individual charged with having aided and abetted a securities law violation.
>
> The test therefore is whether the 'defendant should have been able to conclude that his act was likely to be used in furtherance of illegal activity. Knowledge that a violation is being committed and intent to further the illegal act is not required.' " (quoting SEC v. Rega, CCH Fed. Sec. L. Rep. [Current] ¶95, 222, at 98,146 (S.D.N.Y. July 3 , 1975) (D45; 446a).

It is apparent from the decision of the district court that all defendants were held liable under Section 10(b) of the 1934 Act and Rule 10b-5 based on the application of a negligence standard. In fact, such standard was a correct application of the law as it existed at the time of the

decision.* However, after the decision of the Supreme Court in Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), it is no longer the law.** Hochfelder held that a civil action for damages under Section 10(b) and Rule 10b-5 cannot be sustained in the absence of proof of scienter -- intent to deceive, manipulate, or defraud.

The Supreme Court in that decision (fn. 12) stated that it had no need to consider the question whether scienter is a necessary element in an action under those provisions for injunctive relief. However, as Justice Blackman pointed out in his dissenting opinion, the statute and the rule are the same irrespective of the identity of the plaintiff. An "attempted distinction based upon the identity of the plaintiff ignores the crucial difference between the question of violation and the question of entitlement to ... relief." Id., at 217-18.

Therefore, the scienter standard held in Hochfelder to apply to private damage actions applies

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* The two decisions of this Court which the district court cited in this respect are SEC v. Spectrum, Ltd., 489 F.2d. 535, 541 (2d Cir. 1973) and SEC v. Management Dynamics, 515 F.2d 801, 811 (2d Cir. 1975).

** Coincidentally, the decision below was rendered on the same day Hochfelder was handed down -- March 30, 1976.

equally in a suit by the SEC for injunctive relief. Since Hochfelder was rendered, a decision in the Southern District of New York has so held. SEC v. Bausch & Lomb, 420 F.Supp. 1226 (SDNY 1976).

There, Judge Ward, after analyzing the grounds for the decision in Hochfelder stated:

> "This Court believes that the Hochfelder holding must be read to impose a scienter requirement in this suit for injunctive relief brought by the SEC. Although not obliged to reach the question by the facts of that case, the Supreme Court used reasoning which appears to compel that result.
>
> The Supreme Court found, 'the language and history of §10(b) dispositive.' ... These stand at least as conclusively when the SEC is plaintiff. The private damage action brought under this section is a creation of the courts. ... If the 'language and history of §10(b) [are] dispositive' as to the scienter question in private actions, must they not also be so in "SEC suits for injunctions [which] are 'creatures of statute'. Management Dynamics, supra at 808. Argument drawing upon the words of §10(b) and the history, legislative and administrative, of both §10(b) and Rule 10b-5 applies equally to private suits and actions brought by the Commission. Only policy considerations -- which have traditionally been applied to distinguish the two kinds of cases -- TGS, at 868 (Friendly, C.J., concurring) could support a contrary argument yet the Court noted:
>
> 'As we find the language and history of §10(b) dispositive of the appropriate standard of liability, there is no occasion to examine the additional considerations of 'policy,' set forth by the parties,... '44 U.S.L.W. at 4460, n.33.
>
> As this Court reads the majority opinion in

> Hochfelder, scienter must be pleaded and proved whether suit is brought by the SEC or by a private litigant." Id. at 1240-41

Certainly one charged with aiding and abetting a §10(b) violation must be shown to have knowingly assisted that which he knew to be a violation of the law. The principle set forth by the Sixth Circuit in SEC v. Coffey, 493 F.2d 1304, 1316 (6th Cir. 1974), decided before Hochfelder, is indicative of the minimum which is required for a finding of liability for aiding and abetting:

> "... we find that a person may be held as an aider and abettor only if some other party has committed a securities law violation, if the accused party had general awareness that his role was part of an overall activity that is improper, and if the accused aider-abettor knowingly and substantially assisted the violation."

This record is palpably devoid of any such evidence. After Hochfelder, the imposition of liability -- either for a violation or for aiding and abetting a violation -- requires even more. There must be proof of intent to deceive, manipulate or defraud.

The district court decision in Bausch & Lomb correctly holds that such proof, since it is necessary to establish a violation, is required in a civil action brought by the SEC. There was no such proof here. The alleged liability of all these defendants was adjudicated based upon

a negligence standard which the Supreme Court held to be incorrect. They are therefore entitled, at a minimum, to a new trial.

POINT IV

THE DISTRICT COURT'S CALCULATIONS OF PROFIT DISGORGEMENT WERE CLEARLY ERRONEOUS

There are five major deficiencies in the ancillary relief calculations made by the district court (SD; 459a): the evidence of the relevant transactions was incomplete, inaccurate, secondhand, and unreliable; serious mathematical errors were made; defendants were charged with profits realized by accounts in which they had no beneficial interest and from which they received no funds; profits realized in transactions between defendants were included; and losses were not netted from profits. The combined effect was a wholly imaginary and punitive award, based upon charts by a non-expert witness the admission of which was unwarranted, improperly granting special status to the SEC as a litigant in this proceeding.

(1) Inaccurate and incomplete evidence of transactions. The district court made its calculations exclusively from charts offered by the SEC in support of its manipulation claim (i.e. PX7, 9, and 10; 80a, 89a and 93a). The pervasive deficiencies of those charts have been discussed above. The charts are the result of a sampling of the trading in the securities of Beneficial Labs. They do not purport to be a full and complete recapitulation of all trading. The SEC investigator who

prepared the charts admitted that he had surveyed only 20 or so of the thousands of broker-dealers in this country. (PR66; 58a). Obviously a trading survey or sampling cannot be the source material for precise calculation of profits actually realized by particular individuals. A survey is by definition less than complete; whereas exact calculation of profits demands a complete record.

In connection with settlement of the judgment in the district court defendants requested a reference or a supplemental hearing in order to develop accurate information on actual profits. Absent such a hearing the district court should have denied ancillary relief, as there is no excuse for plaintiff's failure to make a proper record during the trial itself.

A full recitation of defendants' purchases and sales would be contained in the periodic statements received by the defendants from the various broker-dealers with whom they maintained accounts. It would be a routine matter for the SEC to amass a full set of those statements. The details of the few private transactions (i.e., those not made through broker-dealers) could be offered through the testimony of the defendants themselves. However plaintiff made no effort to introduce

any evidence of the actual transactions, apparently content to rely upon the admittedly incomplete survey reflected by exhibits 7, 9, and 10.

Nor is the incompleteness of exhibits 7, 9, and 10 a subtle matter. There are numerous omissions apparent on the face of the charts. For instance, exhibit 10 shows Mr. Drucker selling 1000 units in October, 1972, and 1250 units in November, 1972, but it fails to show any purchases at any time. This obviously is erroneous because Mr. Drucker's sales were not alleged to have been, and were not in fact, "short sales". He made delivery of the securities. In that the sales proceeds exceeded $75,000, failure to take account of the purchase cost severely distorted the profit calculation.

Similarly, exhibit 7 shows Mr. Drucker to be a seller of 10,000 shares of Beneficial Labs common stock (purportedly a $100,000 sale). Mr. Drucker denies the existence of any such sale. Plaintiff's documentation for this transaction allegedly is contained in exhibit 8, the order tickets and confirmations on which the SEC claims to have based its charts. However, exhibit 8 contains evidence of only one 10,000 share trade, and Mr.

Drucker was only one of several sellers, to the extent of 3,250 shares. (87-88a). This, of course, demonstrates a blatant falsity in exhibit 7, of highly material proportions (a $67,500 exaggeration), and remarkably, the falsity is proved by the SEC's own exhibit.

Exhibits 7, 9, and 10 also allege transactions for which there is no documentary support in Exhibit 8. For example, exhibit 7 alleges that Mr. Drucker sold 1500 shares of Beneficial Labs common stock on July 12, 1972. There is absolutely no support for that allegation in exhibit 8.

Obversely, exhibits 7, 9, and 10 omit transactions which exhibit 8 indicates occurred. For example, exhibit 7 fails to include a purchase by Mr. Drucker of 600 shares of Beneficial Labs common stock on November 9, 1972, at $17 per share. (PX8). One need not look very far to discover the reason for the SEC's convenient omission of this purchase. At $17 per share this was very high basis stock, and the loss which Mr. Drucker sustained upon sale of this stock would have reduced the disgorgement award substantially.

Another example exhibit 9 fails to include a purchase by Commonwealth Chemical Corp. of 2,000 Beneficial Labs warrants at $20.25 on January 15, 1973. That omitted purchase is proved by the SEC's own exhibit 8 (82-88a), and, of course, its inclusion would have reduced the disgorgement due from Commonwealth by more than $40,000.

Numerous additional examples could be recited, on and on. However, the point is apparent. The charts from which the district court calculated disgorgement are admittedly incomplete and plainly unreliable. The SEC simply failed to offer evidence sufficient to support a true computation.

(2) Mathematical errors. Again the computations regarding Mr. Drucker provide the best example of serious mathematical error. The district court concluded that Mr. Drucker had actual, realized profits of $173,475, based on a FIFO analysis, ignoring sales which according to the SEC charts occurred before purchases (an obvious impossibility in the absence of "short sales", which admittedly did not occur). Appendix 1

to this brief relists all of Mr. Drucker's transactions as shown by the SEC's charts. The FIFO gain does not exceed $24,500. The district court's assessment of profits at $173,475 is clearly erroneous.

(3) Unsupported combination of accounts. In computing the disgorgement award the district court assumed that certain defendants owned beneficially certain accounts of other people. There is no support in the record for the assumption.

Tables I and II of the court's supplemental memorandum (466-467a) show what was done. Mr. Drucker was ordered to disgorge profits purportedly realized in his own account plus those purportedly realized in the accounts of Lori Rukasin, Dorothy Drucker, Dorothy Rukasin, R. Drucker c/f Susan, R. Drucker c/f Julie, and R. Drucker c/f Cheryl. In its original decision the court had found that Mr. Drucker "controlled" the investment decisions made for those accounts. However, there never has been a finding that Mr. Drucker received any funds from any of those accounts. There is a substantive difference between making trading decisions and receiving profits. The lower court's assumption that the two are equivalent is erroneous.

Plaintiff made no effort to prove, and did not prove, that Mr. Drucker received any funds from any of the accounts for which he made trading decisions. That missing proof is an indispensable prerequisite to any judgment ordering disgorgement of profits actually realized.

The same error was committed in calculating the profits realized by Mr. Kleinman. He was ordered to disgorge profits purportedly realized in the account of one Regina Sinofsky. Mrs. Sinofsky testified at trial that Mr. Kleinman made only the investment advisory decisions for her account. (32; 115a). The SEC did not ask Mrs. Sinofsky whether Mr. Kleinman received any funds from the account. Nor was any other effort made to prove that Mr. Kleinman received any funds from the Sinofsky account, and as a result, the record is devoid of any support for the direction that Mr. Kleinman disgorge profits from that account. Again the court mistakenly equated decision-making "control" and beneficial ownership.

(4) Profits between defendants. Any profit realized by one defendant in trading Beneficial Labs securities with another defendant of course should be

irrelevant in the calculation of disgorgement. Disgorgement is explicity and exclusively for the benefit of those members of the public who dealt with the defendants, and no public person suffered any loss in connection with any transaction between defendants. Concomitantly, no defendant will be permitted to share in any disgorgement, and therefore there will be no recipient for any profit which resulted from transfer of a defendant's funds. Disgorgement of profits between defendants thus would be a pointless and punitive act, yet the district court erroneously included intra-defendant profits in its computations. For example, according to the SEC's charts Mr. Kleinman purchased from the public 4,000 shares of common stock at $5 per share. He later sold 300 shares to Commonwealth (also a defendant) at $15 per share, realizing a $3,000 gain, which the district court included in the disgorgement award despite the fact that Mr. Kleinman received the sales proceeds from another defendant, not from the public.

Similarly, according to the SEC's charts, Miss Sharpe purchased 500 units from Commonwealth at $2-5/8 per share. She later sold 50 units back to

Commonwealth at $36 per share, realizing a $1,668.75 gain as a result of the price paid by another defendant. Again the district court erroneously included the gain in the disgorgement award.

Of course this inclusion of intra-defendant profits had the effect of pointlessly inflating the ancillary relief award, thus making the award a penalty, whereas the true, and only permissible function of disgorgement is to return profits realized <u>from the public</u>.

(5) <u>Failure to net losses from profits</u>. The district court established an arbitrary cut-off date (March 2, 1973) for the calculation of profits realized by the defendants. On March 2, 1973, most of the defendants owned various Beneficial Labs securities. As incomplete as plaintiff's exhibits 7, 9, and 10 are, they nevertheless support this fact. For instance, they show that Miss Sharpe owned 450 warrants and 300 shares of common stock, that Mrs. Kleinman owned 100 units, and that Mr. Kleinmen owned 1,500 units and 1,750 shares of common stock. At the trial defendants sought to introduce evidence

of the depreciation in value of their holdings on March 3, 1973. (DXD, E; 390a, 401a). This proof, which was excluded would have shown that defendants ultimately did not realize net profits, and that the illusion of profit was created artificially by cutting off the calculations at March 2, 1973.* In the end the losses sustained by the defendants on the securities which they held on March 2, 1973, more than offset profits realized prior to that date, even if profits are based upon the SEC's erroneous charts. There are no profits left to disgorge, which again demonstrates the essentially punitive nature of the ancillary relief. Injunctive relief must speak contemporaneously; it must deal with the circumstances which exist at the time of the judgment. Here the judgment violates that precept by arbitrarily cutting off ancillary relief calculations more than three years prior to its date.

* The district court attempts to validate the March 2, 1973, cut-off date by suggesting that losses sustained thereafter resulted from defendant's wrongdoing. (D50; 451a). This of course is erroneous, because Beneficial Labs securities resumed trading after the SEC suspension was lifted, and it was in that subsequent market that defendants' losses were sustained.

All of the decisions dealing with ancillary relief agree that a punitive award may not be made. In _SEC v. Texas Gulf Sulphur Co._, _supra_, the Court held:

> Thus, we hold that the SEC may seek other than injunctive relief in order to effectuate the purposes of the Act, so long as such relief is remedial relief and is not a penalty assessment. (p. 1308).

SEC v. Manor Nursing Centers, Inc., _supra_, is to the same effect.

In both cases the Court placed strict limits on the extent of the ancillary relief. In _Texas Gulf_ the district court was prohibited from ordering disgorgement of profits realized after public disclosure of the inside information. In _Manor Nursing_ the district court was prohibited from ordering disgorgement of profits and income earned on the proceeds of the offering.

> We believe that ordering the disgorging of profits and income earned on the proceeds is in fact a penalty assessment. (p. 1104).

The _Manor Nursing_ decision goes on to emphasize that an ancillary award should not subject the defendants to a judgment greater than that which would be possible in a private action.

Clearly the district court's judgment in this action goes beyond the restraints established in _Texas Gulf_ and _Manor Nursing_. By including profits realized in accounts in which the defendants had no beneficial interest the district court penalized the defendants. They did not receive the funds they are charged with disgorging. By including profits realized on transactions between defendants the district court penalized the defendants. The public was not deprived of any funds as a result of transactions between defendants.

Nor did plaintiff make any effort to prove the amount of damage which actually was sustained by the public. Under the generally accepted "out-of-pocket" method, plaintiff would have to have offered expert testimony as to the true value of the Beneficial Labs securities on the dates when purchased by members of the public. This was not done.

And overshadowing the whole ancillary aware is the problem of unreliable and incomplete source material, which of course is a separately sufficient basis for denying ancillary relief. If relief is not denied, Manor Nursing gives guidance on the procedure to follow in curing a lack of reliable information -- namely, the appointment of a trustee to preserve the status quo while additional proceeding are conducted. In the present case the district court decided not to follow that guidance, and it thereby erred in awarding speculative, and therefore punitive, ancillary relief.

CONCLUSION

In SEC v. Management Dynamics, Inc., supra, this court said:

> We scarcely mean to imply that judges are free to set to one side all notions of fairness because it is the SEC, rather than a private litigant, which has stepped into court. 515 F.2d at 808.

The judgment in this action should be reversed due to the absence of a clear preponderance of credible evidence as to any violation of law, or as to any propensity on the part of any defendant to violate the law. This record is not simply "incomprehensible" and "incoherent" (as the district court found); it is plainly insufficient.

The complaint should be dismissed, or the action should be remanded for a jury trial in which the proper standard of culpability would be applied.

Respectfully submitted,

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Appendix I

ROBERT DRUCKER GAINS ON SALES TO PUBLIC
AS SHOWN BY SEC EXHIBITS USING SEC FIFO
METHOD OF COMPUTATION

Date	Security*	Sales Proceeds	FIFO Basis	Gain
10/3/72	100 W	$ 1,275	$ 800	$ 475
1/23/73	100 W	1,025	800	225
7/12/72	1500 C	12,750	7,500	5,250
7/14/72	1100 C	9,625	5,500	4,125
7/17/72	500 C	4,375	2,500	1,875
12/11/72	100 C	2,050	500	1,550
1/24/73	100 C	1,250	500	750
1/30/73**	2050 C	20,500	10,250	10,250
				$24,500

* W = warrant

C = common stock

** Disputed trade; part of alleged 10,000 share trade for which documentation is lacking.